

Message Text

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ACTION EUR-08

INFO OCT-01 SS-14 ISO-00 TRSE-00 CEA-01 FRB-01 NSC-05
SP-02 PA-01 INR-05 CIAE-00 EB-04 OMB-01 EA-06
/049 W
-----062683 110057Z /66

P 110015Z MAR 78
FM AMEMBASSY OTTAWA
TO SECSTATE WASHDC PRIORITY 6613
AMEMBASSY BERN
AMEMBASSY BRUSSELS
AMEMBASSY LONDON
AMEMBASSY PARIS
AMEMBASSY TOKYO

C O N F I D E N T I A L SECTION 01 OF 02 OTTAWA 01233

LIMDIS

USOECD, USEEC

DEPT PASS CEA, TREAS, FRB

E.O. 11652: GDS
TAGS: EFIN, ECON, CA
SUBJECT: BANK OF CANADA INCREASES BANK RATE TO 8.0 PERCENT

1. SUMMARY. BANK OF CANADA (BOC) HAS INCREASED BANK RATE FROM 7.5 PERCENT TO 8 PERCENT. MOVE AIMED AT DEFENDING CANADIAN DOLLAR EXCHANGE RATE. RISE IN BANK RATE WILL TRIGGER INCREASE IN CHARTERED BANKS' PRIME LENDING RATES AND IS INDICATIVE OF POLICY DILEMNA GOC COULD FACE IN COMING MONTHS. CANADIAN DOLLAR STRENGTHENED DAY FOLLOWING ANNOUNCEMENT. END SUMMARY.

2. BOC ANNOUNCED ON EVENING OF MARCH 8 THAT BANK OF CANADA BANK RATE (I.E., DISCOUNT RATE) WOULD BE INCREASED
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FROM 7.5 PERCENT TO 8 PERCENT EFFECTIVE IMMEDIATELY. BANK RATE HAD BEEN AT 7.5 PERCENT SINCE MAY 9, 1978. IN ANNOUNCING BANK RATE INCREASE, BOC GOVERNOR BOUEY NOTED THAT WHEREAS SHORT TERM INTEREST RATES WERE ABOUT FOUR PERCENTAGE POINTS HIGHER IN THE U.S. THAN IN CANADA IN THE FALL OF 1976, THE DIFFERENCE IS NOW ABOUT ONE-HALF OF ONE PERCENTAGE POINT. HE ALSO NOTED THAT MONEY

SUPPLY (M1) GROWTH WAS ABOVE THE CENTER OF BOC'S TARGET RANGE AND SAID THAT SOME INCREASE IN RATE WOULD MODERATE DOWNWARD PRESSURE ON EXCHANGE RATE AND CONTRIBUTE TO MORE ORDERLY CONDITIONS IN EXCHANGE MARKETS. IN TALKS WITH SECRETARY BLUMENTHAL MARCH 9, FINANCE MINISTER CHRETIEN SAID FRANKLY MOVE WAS TAKEN TO DEFEND EXCHANGE RATE.

3. MOVE HAS HAD EXPECTED SHORT RUN EFFECT OF STRENGTHENING CANADIAN DOLLAR EXCHANGE RATE. CANADIAN DOLLAR OPENED AT 88.92 U.S. CENTS AND CLOSED ABOUT 89 CENTS ON MARCH 9, UP FROM MARCH 8 CLOSING RATE OF 88.75.

4. IN RESPONSE TO RISE IN BANK RATE, TORONTO DOMINION BANK AND ROYAL TRUST HAVE ANNOUNCED INCREASES IN THEIR PRIME LENDING RATES FROM 8.25 PERCENT TO 8.75 PERCENT. OTHER CHARTERED BANKS CAN BE EXPECTED QUICKLY TO FOLLOW SUIT.

5. COMMENT. CANADIAN BANK RATE WAS REDUCED FOUR TIMES FROM 9.50 PERCENT IN ONE-HALF PERCENTAGE POINT STEPS BETWEEN MARCH 1976 AND MAY 1977 AS INFLATION ATTENUATED, RECOVERY REMAINED HESITANT, AND GROWTH OF MONEY SUPPLY REMAINED AT OR BELOW SUCCESSIVELY LOWER TARGET RATES OF GROWTH. THE MONEY SUPPLY GROWTH IS NOW AT 9.8 ANNUAL RATE FROM JUNE 1977 BASE --I.E., WELL INSIDE THE SEVEN TO ELEVEN PERCENT TARGET RANGE RATE OF GROWTH. HOWEVER,

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WITH UNEMPLOYMENT AT 8.3 PERCENT, DECISION TO INCREASE BANK RATE TO DEFEND EXCHANGE RATE WAS CLEARLY NOT EASY TO MAKE.

6. CANADIAN DOLLAR HAS BEEN FOLLOWING U.S. DOLLAR DOWN WITH RESPECT TO OTHER CURRENCIES, BUT HAS ALSO REMAINED VULNERABLE WITH RESPECT TO THE U.S. DOLLAR. SLIDE IN CANADIAN DOLLAR WAS STABILIZED FOR AWHILE FOLLOWING ANNOUNCEMENT IN OCTOBER OF GOC INTENTION TO SEEK U.S. DOLS 1.5 BILLION STANDBY CREDIT. RISE IN U.S. SHORT TERM INTEREST RATES AND DECLINE IN CANADIAN RATES DURING 1977 REDUCED SHORT TERM INTEREST RATE DIFFERENTIALS IN FAVOR OF CANADA. THE LACK OF AUTONOMOUS CAPITAL INFLOWS FROM NEW SECURITY ISSUES ABROAD BY CANADIAN BORROWERS TOGETHER WITH POSTPONEMENT OF CONVERSION OF PRIOR BORROWING IN FEBRUARY LED TO SHARP DOWNWARD PRESSURE ON THE EXCHANGE RATE, PUSHING IT THROUGH THE 90 U.S. CENTS LEVEL. IT ALSO LED TO THE LOSS OF OVER DOLS 700 MILLION IN RESERVES IN FEBRUARY AND FORCED THE GOC TO DRAWDOWN ITS U.S. DOLS 1.5 BILLION STANDBY CREDIT AND TO ANNOUNCE ITS OWN U.S. DOLS 750 MILLION BOND ISSUE IN NEW YORK. WITH CONTINUED TURBULENCE IN FOREX MARKETS,

THE CANADIAN DOLLAR REMAINED VULNERABLE TO MARKET RUMORS
AND INTERVENTION TO MAINTAIN ORDERLY MARKETS REPORTEDLY
RESULTED IN THE LOSS OF ANOTHER 120 MILLION IN RESERVES
IN THE FIRST WEEK OF MARCH.

7. WE BELIEVE GOC'S ASSESSMENT IS THAT WHILE 90 U.S.
CENT CANADIAN DOLLAR HAS RESTORED COMPETITIVENESS OF
CANADIAN EXPORTS LOST IN RECENT YEARS BY DOMESTIC COST
AND PRICE INCREASES RISING FASTER THAN IN U.S., EXCHANGE
RATE MUCH BELOW THAT LEVEL IS UNDESIRABLE BOTH POLITICALLY
AND FROM VIEWPOINT OF FURTHER IMPORTED INFLATION.
IN SITUATION WHERE FORCES WERE OPERATING TO DEPRESS
EXCHANGE RATE TOO FAR AND TOO FAST, GOC ASSESSMENT WAS
APPARENTLY THAT OFFICIAL BORROWING ABROAD AND INTER-
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C O N F I D E N T I A L SECTION 02 OF 02 OTTAWA 01233
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VENTION ALONE WOULD BE INADEQUATE TO STEM TIDE AND THAT
SOME TIGHTENING OF DOMESTIC MONETARY CONDITIONS BY
INCREASING BANK RATE WAS NECESSARY. RISE OF ONE-HALF
PERCENTAGE POINT IN BANK RATE WILL PROBABLY NOT HAVE
SERIOUS IMPACT ON GROWTH. HOWEVER, SHOULD DOWNWARD

PRESSURE ON EXCHANGE RATE CONTINUE, GOC WILL HAVE DIFFICULT CHOICE BETWEEN FURTHER FOREIGN BORROWING AND INTERVENTION; PERMITTING DEPRECIATION AND ACCEPTING MORE RAPID INFLATION; OR RAISING INTEREST RATES TO POINT WHERE ADVERSE IMPACT ON GROWTH COULD BE MORE SEVERE.

8. WITH FEDERAL ELECTIONS PENDING, PROBABLY IN JUNE, FURTHER DECLINE IN THE EXCHANGE RATE VIS-A-VIS U.S. DOLLAR IS APT TO BE PORTRAYED BY POLITICAL OPPOSITION AS LACK OF INTERNATIONAL CONFIDENCE IN TRUDEAU GOVERNMENT.
ENDERS

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Message Attributes

Automatic Decaptoning: Z
Capture Date: 01 jan 1994
Channel Indicators: n/a
Current Classification: UNCLASSIFIED
Concepts: DOLLAR, BANK RATES, FOREIGN EXCHANGE RATES, ECONOMIC PROGRAMS
Control Number: n/a
Copy: SINGLE
Draft Date: 11 mar 1978
Decaption Date: 20 Mar 2014
Decaption Note: 25 YEAR REVIEW
Disposition Action: RELEASED
Disposition Approved on Date:
Disposition Case Number: n/a
Disposition Comment: 25 YEAR REVIEW
Disposition Date: 20 Mar 2014
Disposition Event:
Disposition History: n/a
Disposition Reason:
Disposition Remarks:
Document Number: 1978OTTAWA01233
Document Source: CORE
Document Unique ID: 00
Drafter: n/a
Enclosure: n/a
Executive Order: GS
Errors: N/A
Expiration:
Film Number: D780108-1086
Format: TEL
From: OTTAWA
Handling Restrictions:
Image Path:
ISecure: 1
Legacy Key: link1978/newtext/t19780379/aaaacoog.tel
Line Count: 180
Litigation Code IDs:
Litigation Codes:
Litigation History:
Locator: TEXT ON-LINE, ON MICROFILM
Message ID: 6ec618c9-c288-dd11-92da-001cc4696bcc
Office: ACTION EUR
Original Classification: CONFIDENTIAL
Original Handling Restrictions: LIMDIS
Original Previous Classification: n/a
Original Previous Handling Restrictions: n/a
Page Count: 4
Previous Channel Indicators: n/a
Previous Classification: CONFIDENTIAL
Previous Handling Restrictions: LIMDIS
Reference: n/a
Retention: 0
Review Action: RELEASED, APPROVED
Review Content Flags:
Review Date: 03 jun 2005
Review Event:
Review Exemptions: n/a
Review Media Identifier:
Review Release Date: n/a
Review Release Event: n/a
Review Transfer Date:
Review Withdrawn Fields: n/a
SAS ID: 3360964
Secure: OPEN
Status: NATIVE
Subject: BANK OF CANADA INCREASES BANK RATE TO 8.0 PERCENT
TAGS: EFIN, ECON, CA
To: STATE BERN
Type: TE
vdkvgwkey: odbc://SAS/SAS.dbo.SAS_Docs/6ec618c9-c288-dd11-92da-001cc4696bcc
Review Markings:
Sheryl P. Walter
Declassified/Released
US Department of State
EO Systematic Review
20 Mar 2014
Markings: Sheryl P. Walter Declassified/Released US Department of State EO Systematic Review 20 Mar 2014